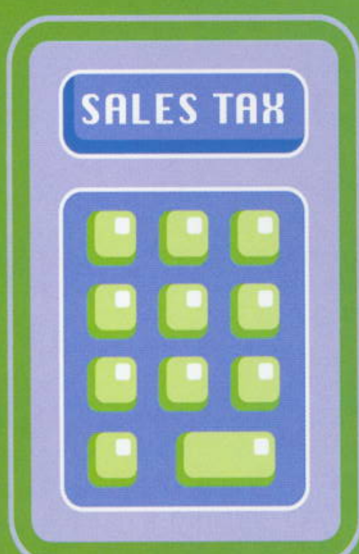
feature

The Complex World of Collecting Sales and Use Tax

Jacob Barron

When consumers think of sales tax, they think of the few extra cents they pay at the grocery store on Saturday morning or, if they live in Delaware, they think about how nice it is to have that charge left out of all their purchases. In B2B transactions, however, these sums of money can be quite large and, while in many cases the administration of sales taxes dwells only in the background of the business landscape, it's important for credit and collection managers to understand how this tax works and what can happen if it is ignored.



"They don't teach it in school, but it's really something you need to do," said Michael Kochis, Tax Manager at MGE UPS Systems, Inc. "It's a necessary evil."

The body of law behind sales and use tax is vast and widely varied. From state to state, county to county, municipality to municipality, things can often change drastically and percentages can rise and fall depending on the direction your company's goods are traveling. It's also important to know the difference between sales and use taxes, as they are complimentary but not interchangeable.

Sales tax is a tax imposed on tangible personal property by a retailer of that property; use tax is a complement to sales tax imposed on the consumer of tangible property. This applies to situations where goods are bought from one company by another company which uses the goods in another product, as in manufacturing where raw materials are used to make another product, or a company that stores or consumes certain goods. The difference between the two types of tax also deals with where business is being conducted. If the transaction is occurring within state lines, then sales tax is collected, but if the transaction crosses state lines and the selling company has a presence in the state, use tax is collected.

When You Have to Collect

In some instances, a company may not have to bother with collecting sales tax at all, so it's important to know when it's required and when it's not. "You're required to collect when you have nexus," said Diane Yetter, Founder of the Sales Tax Institute in Chicago, IL and President of the sales tax consulting firm Yetter Consulting Services, Inc. Yetter explained that nexus is most commonly understood to mean a substantial physical presence in a state or municipality. "You have an office; you have a physical presence," said Yetter.

A company can also have nexus under other circumstances as well. "If you have people that travel, like traveling sales people or repair people," said Yetter, "these can create nexus for you." If a contingent of your staff frequently travels into a state, it's important to be certain of whether or not you're required to collect sales tax on the business they conduct.

Certain items are also taxable while others aren't, generally along the lines of tangible and intangible property. "Most states don't require tax on intangible property," said Yetter. However, the definition of what constitutes tangible and intangible can vary from state to state. For example, Illinois, Yetter's home state, requires that sales tax be applied to sales of computer software, even if it's transmitted in an intangible format. Yetter noted that other intangible items, like services, training or the installation of a tangible item, could be taxable or non-taxable depending on the locale. "It's based on your business and where you're selling," she added. The type of customer your company sells to also determines taxability. Sales to the federal government are exempt, but some states abide by their own statutes and charge sales tax on transactions to governmental bodies. Sales tax also varies depending on how the product is to be used. Items bought for the sole purpose of resale are often exempt from sales tax and certain products that are used in certain ways, like being bought as part of another larger product, can make a transaction exempt to sales tax. Yetter said all businesses must know "what the rules are and when they apply."

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Taxing

Once a company has examined all of these factors and decided that the customer isn't exempt in any way, then it's time to collect, which brings another slew of questions and conditions into the process before the sale should be completed.

The first and probably most important question is, what rate of tax is required on the transaction. The answer isn't as easy as one might think. According to Kochis, different states have different rules as to who sets the tax rate. Some go by the laws of the state in which business is conducted and others get even more specific into cities, parishes, counties and other smaller municipalities. In rare instances, Kochis said that a company could be forced to charge two sales tax rates. "They may be on a borderline jurisdiction where a city may fall within two counties," said Kochis. This may lead the selling company to charge more for the different rates.

How much sales tax is charged is also a factor of where state law dictates the tax should be sourced. "Most places say the tax that applies is the tax where the customer is," said Yetter, while select other places say the opposite; that the seller's location denotes the tax rate. These regulations also change depending on whether the transaction is inter- or intrastate. The technical terms for these delineations are destination sourcing, charging the tax required by the location of the buyer, and origin sourcing, which is charging the tax required by the location of the seller.

Miscalculations in this area can be misleading and potentially costly. "They have to collect the correct amount of tax," said

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Kochis. "You can't keep any excess taxes." Charging more will only give a company a false idea about the actual amount of money coming from the sale and any excess will eventually have to be remitted to the required jurisdiction. "On the other hand, if you don't collect that much," said Kochis, "you could be held responsible." Collecting too little tax could lead to another hit on your company's balance sheet and could

mean additional penalties come audit season. "You may collect a tax after the fact," said Kochis. However, this is often a difficult thing to accomplish as Kochis noted that, typically, clients aren't going to bother paying after the fact when the error is part of the selling company's negligence. "Most companies have a tough time going back to get customers to reimburse them," added Yetter.

Documentation and Dealing with Audits

Documentation of sales tax collected or waived is an extraordinarily important part of the business because during an audit, all of the aforementioned items need to be documented in some way. If one of your customers is sales tax exempt, then it needs to be documented. "If you sell to a customer and they say they're not taxable," said Kochis, "then you need the resale certificate." A resale certificate provides a seller with documentation proving that the goods sold to a particular customer are going to be resold and are, therefore, not taxable. The equivalent document when a buyer isn't reselling them but still qualifies for exemptions is merely called an exemption certificate.

Like other sales and use tax regulations, required documentation varies from state to state. Yetter noted that when it comes to an audit, documentation is also necessary to prove to whom you sold goods. "If you sold… to a government agency," said Yetter, "you might just need the invoice." She added, however, that many other states require an actual exemption certificate, regardless of the fact that your customer is automatically considered exempt.

After a company has done all that it can to account for correct sales taxes and documentation, then it's ready for an audit by the state in which it's doing business. "When you're getting audited, you need to know all these things," said Yetter. Failure to collect the right amount of tax, Yetter noted, can lead to some extremely dire

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consequences. "One thing to keep in mind; the average sales tax rate across the U.S. is close to 8%," she said. "Your risk is 8% of your gross revenue."

During the audit, penalty fees can balloon into huge percentages of company sales revenue. "If you do it wrong, you could be wiping out all of your profit," said Yetter. "Businesses get charged penalties and interest," added Kochis. This means that, should a company fail to collect, it will be subject to the percentage tax it failed to collect for each instance of error, in addition to interest on those transactions and penalties on top of that. Additionally, audits typically occur on an every-three-years basis, so a 10% interest charge on any fees that a company failed to levy are multiplied by three, adding a 30% interest charge to the tax fees that have been backing up over that period of time. Very large companies, which are most frequently targeted for audits, can often go for eight to 10 years between audits, making these fees even greater. "It can get quite costly," said Yetter.

Still, these circumstances are the absolute worst case. "You can't circumvent the audit," said Kochis, adding that states aren't looking for a completely error-free audit. "You're not going to be perfect," he said. The important task is to prepare as best as you can and cut your losses by accounting for any sales tax your company is required to collect.

Yetter added that a company's penalty fees are often a function of how frequently they've made errors when filing and remitting sales tax. Companies with grievously high error rates often pay larger penalty percentages, she said, while companies with minor errors can often get away with few or no penalty fees.

In the end though, protecting a company from sales and use tax penalties should be a preventative measure. "The best way is to be prepared for it," said Kochis, who added that it's important to take care of everything on the front end, rather than after the fact, when the auditor is at your doorstep.

Information

With all of this information, it's important for companies to have all the necessary and current information before making a sale and collecting the correct amount of tax. "There is no free source," of information, said Yetter. However, Yetter recommends checking in with state departments of revenue for accurate and up-to-date tax information. "You need to get it from the state," she said. Yetter also recommended that companies check out the Federation of Tax Administrators' website (www.taxadmin.org), which provides users with a variety of resources; some of which are free. State CPA societies also yield a wealth of valuable information, said Yetter, as do some industry specific associations.

Yetter's company, the Sales Tax Institute (www.salestaxinstitute.com), also provides businesses with information on correctly administering sales and use tax and also offers courses on the matter.

"The key is, when you're talking about collections, it's not a tax that should ever be the seller's burden," said Yetter. "If you don't do it right, then it becomes a tax that you never should've paid." At the end of the day, business creditors take enough hits to the bottom line. With payment delinquency still a problem and a new wave of corporate bankruptcies predicted for the coming months, it's important for companies to protect themselves from penalties they should never owe in the first place by accounting for tax from the beginning and working diligently to collect correctly. ■

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